

## ANALYSIS OF ORIGINAL BILL

Author: Hurt Analyst: Colin Stevens Bill Number: SB 1993

Related Bills: \_\_\_\_\_ Telephone: 845-3036 Introduced Date: 2-20-98

Attorney: Doug Bramhall Sponsor: \_\_\_\_\_

SUBJECT: Federal Income and Employment Taxes deduction

### SUMMARY

Under the Personal Income Tax Law (PITL) and Bank and Corporation Tax Law (B&CTL), this bill would allow a deduction equal to the amount of federal taxes paid for income tax, Social Security, Medicare, and unemployment insurance (UI).

### EFFECTIVE DATE

This bill would apply to taxable or income years beginning on or after January 1, 1998.

### SPECIFIC FINDINGS

Under **federal and State law**, deductions are classified either as those expenses which are subtracted from gross income to arrive at adjusted gross income (AGI) (so-called "above the line deductions") and those expenses that are subtracted from adjusted gross income in arriving at taxable income (so-called "below the line deductions").

**Current federal law** allows deductions for some taxes paid to state, local and U.S. possessions. Taxes are charges imposed on persons or property by a governmental authority to raise funds for the support of government. Only true tax payments are deductible as taxes. Under **federal and state laws**, an individual generally may deduct taxes only if he itemizes deductions (for state, an individual must file on Form 540 or Form 540A in order to itemize). Taxes generally are deductible only by the person on whom they are imposed.

**Current federal and state laws** allow taxpayers to deduct ordinary and necessary business expenses paid or incurred during the year as part of a trade or business. Employers' contributions to state UI funds are generally deductible as taxes. Additionally, one half of the self-employment tax, which is equal to one-half of 15.30% of earnings (12.40% of the amount of income under \$68,400 and 2.90% of the entire remaining self-employment income with no ceiling) is deductible in determining the taxpayer's adjusted gross income.

### DEPARTMENTS THAT MAY BE AFFECTED:

\_\_\_\_ STATE MANDATE

\_\_\_\_ GOVERNOR'S APPOINTMENT

#### Board Position:

\_\_\_\_ S \_\_\_\_ O  
\_\_\_\_ SA \_\_\_\_ OUA  
\_\_\_\_ N \_\_\_\_ NP  
\_\_\_\_ NA \_\_\_\_ NAR  
\_\_\_\_ X \_\_\_\_ PENDING

#### Agency Secretary Position:

\_\_\_\_ S \_\_\_\_ O  
\_\_\_\_ SA \_\_\_\_ OUA  
\_\_\_\_ N \_\_\_\_ NP  
\_\_\_\_ NA \_\_\_\_ NAR  
DEFER TO \_\_\_\_\_

#### GOVERNOR'S OFFICE USE

Position Approved \_\_\_\_  
Position Disapproved \_\_\_\_  
Position Noted \_\_\_\_

Department Director Date  
Gerald H. Goldberg 4/13/98

Agency Secretary Date

By: \_\_\_\_\_ Date

State law allows a credit for taxes paid to other states, but does not allow a deduction for federal income tax or Social Security tax.

**Federal law** imposes a number of taxes on individuals, corporations and other entities, including Social Security and unemployment taxes.

For taxpayers who itemize deductions (those taxpayers whose deductions are greater than allowed by the standard deduction), California makes various adjustments to federal adjusted gross income. These adjustments include increasing federal adjusted gross income by the amount of California state income taxes paid that are ineligible for deduction at the state level.

Under the PITL and B&CTL, **this bill** would allow as an itemized deduction for individuals and a deduction for corporations an amount equal to the amount of federal tax paid for income tax, Social Security, and UI.

#### Policy Considerations

If this bill is intended to be an itemized deduction, the deduction would benefit only taxpayers who currently itemize or those whose tax liability is greater than the state's standard deduction.

This bill would allow self-employed individuals to receive a state deduction for federal self-employment taxes in addition to the deduction they already receive at the federal level. Since the deduction was taken into account in calculating federal AGI which is the starting point for the completion of a California return, this bill could allow self-employed taxpayers a deduction in excess of the amount of taxes they paid.

#### Implementation Considerations

Clarification of whether the deduction allowed would be net of any refunds, the earned income credit or other credits, or other taxes paid by a taxpayer to the federal government would assist the department in implementing this bill. Further clarification regarding items the author intends to include in the definition of "federal taxes paid" would assist department staff in writing instructions to assist taxpayers in figuring their tax.

This bill indicates that it would allow a deduction for employment taxes imposed by Chapter 22 of the IRC, commencing with Section 3301. However, Chapter 22 commences with 3201, while Chapter 23 commences with Section 3301. Further clarification will be needed to determine whether the author's office intends that this bill allow a deduction for taxes under both Chapters 22 and 23.

Since the deduction for federal taxes would be an itemized deduction, this bill would have the effect of requiring that a much larger number of taxpayers file on Form 540 or 540A rather than file through the simplified telefile program or Form 540EZ, both of which are less expensive to process than Forms 540 or 540A.

### Technical Consideration

All corporate employers currently are entitled to deduct all employment taxes and some excise taxes. Therefore, subdivision (b) of Section 24345.1 is not necessary. Amendment 1 would remove this unnecessary language.

### FISCAL IMPACT

#### Departmental Costs

This bill could result in significant costs to the department as the number of taxpayers required to complete more complicated tax forms increases.

#### Tax Revenue Estimate

The estimated revenue impact of this bill is shown in the following table:

Revenue Impact of SB1993 Effective for Tax Years Beginning on and After January 1, 1998 \$ BILLIONS			
1998-99	1999-00	2000-01	2001-02
(\$7)	(\$5)	(\$5)	(\$5)

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

#### Tax Revenue Discussion

The revenue impact of this bill would be determined by the amount of federal income and payroll taxes paid by California filers and the applicable state tax rates for those filers.

Data from 1993 Personal Income Tax (PIT) tax returns were used to estimate that California PIT taxpayers would pay \$71 billion in federal income taxes in 1998. Data from 1993 Bank and Corporation Tax (B&CT) tax returns were used to estimate that California B&CT taxpayers would pay (after apportioning total federal taxes to California) \$11 billion in federal income taxes in 1998. The employee portion of payroll taxes was estimated to be \$31 billion dollars in 1998. This estimate was made by multiplying the nationwide amount of employee-paid payroll taxes by California's share of total wages (as reported by the IRS' Statistics of Income for 1993). A marginal tax rate of 5% was applied to the PIT and payroll taxes, and a tax rate of 8% was applied to the B&CT taxes to determine the total revenue impact of this proposal. The 8% B&CTL rate is based on the assumption that some corporate taxpayers that have a federal tax liability will not have a California tax liability, and that others will pay the 7% alternative minimum tax rate rather than the standard 8.84% B&CTL tax rate. This analysis assumes that these taxes would be allowed as deductions for AMT purposes as well.

### BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB  
As Introduced February 20, 1998

AMENDMENT 1

On page 2, strike lines 17-20, inclusive.